

VZCZCXRO7145
RR RUEHDBU
DE RUEHMO #0709/01 0821319
ZNY CCCCC ZZH
R 231319Z MAR 09
FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC 2504
INFO RUCNCIS/CIS COLLECTIVE
RHEHNSC/NSC WASHDC
RUCPDOG/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 000709

SIPDIS

STATE FOR EUR/RUS, EEB/IFD
TREASURY FOR TORGERSON AND WRIGHT
DOC FOR 4231/MAC/EUR/JBROUGHER
NSC FOR ELLISON

E.O. 12958: DECL: 03/23/2019
TAGS: [ECON](#) [EINV](#) [EIND](#) [EFIN](#) [RS](#)
SUBJECT: RUSSIAN COMMERCIAL REAL ESTATE: DAY OF RECKONING

REF: 08 MOSCOW 2868

Classified By: ECON M/C Eric T. Schultz for reasons 1.4 (b, d)

Summary

¶1. (C) As the bottom falls out of Russia's commercial real estate market, developers are scrambling to refinance hundreds of millions of dollars of debt to complete projects in the face of disappearing cash flows. Tight financing and lack of demand have halted commercial development projects throughout Russia, including showpieces such as Moscow's Russia Tower, once slated to be Europe's tallest building. Many developers will not survive and banks will likely end up acquiring collateralized assets instead of receiving loan repayments. End summary.

Rental Rates Plummeting

¶2. (SBU) On the back of explosive growth, which saw rental rates for commercial property double from March 2007 to March 2008 and quadruple from 2001, developers and banks poured money into developing commercial space in Moscow. As Moscow commercial rents overtook those of New York, Tokyo, and San Francisco and pulled even with London, developers took out hundreds of millions of dollars in loans to construct office buildings throughout central Moscow.

¶3. (SBU) Even before the crisis hit Russia in September, it was becoming clear that the fundamentals did not support the rate of construction. According to Jones Lang Lasalle, Moscow commercial vacancy rates more than quadrupled over the course of 2008, from 3.2 percent to 14.3 percent. This trend initially led to a stabilization of prices in the first part of 2008 and then a sharp drop of over 26 percent in the fourth quarter of 2008 as the economic crisis took hold. Analysts expect that the situation will worsen in 2009 as corporate tenants throughout Moscow cut staff, go out of business, and/or use market conditions to renegotiate the terms of their leases.

Construction Immobilized

¶4. (C) One of the first casualties of the economic crisis in Russia was the construction industry, which ground to a halt in September. (Reftel) Subsequently, the news became grimmer by the week, with developers announcing an

ever-lengthening list of suspended projects. Theoretically, developers with cash on hand were able to take advantage of lower prices and the greater availability of building materials and labor. But, Sergey Kanukhin, President of the Russian Realtors Guild, told us that the lack of demand for their final product caused many to think twice about using up their cash resources.

¶5. (U) Figures from December 2008 show that the y-o-y increase in construction activity from December 2007 was 0.1 percent, essentially zero. While construction firms are low overhead affairs, they have disappeared at a prodigious rate, along with many jobs primarily filled by migrant labor. (Note: Human Rights Watch estimated that of the 9 million migrants that worked in Russia, approximately 40 percent of them were employed in construction. As these migrants have lost their jobs, remittances to the Central Asian countries they come from have fallen. End note.)

¶6. (C) Julia Gordeyeva, Deutsche Bank Real Estate Analyst, told us that construction was an engine of growth. She noted that related sectors, such as steel, construction machinery, advertising, and design (exterior and interior), had all seen job losses resulting from the building halt. Aleksandr Andreyev, Deputy General Director for Strategic Planning of Rospadskaya, said that the coking coal company also relied on construction activity and was "waiting until the end of winter" to see what the construction market looked like before taking any decisions about reducing jobs.

Vanity Projects Mothballed

MOSCOW 00000709 002 OF 002

¶7. (C) Vanity projects also have not been spared, even if sponsored by well-connected oligarchs. A good example is Shalva Chigirinsky, the billionaire owner of the S T Group whose wealth comes from Moscow real estate, which has enviable connections to the Moscow City Government and Inteko's Elena Baturina (Moscow Mayor Luzhkov's wife), and from the oil and gas conglomerate, Sibir Energy. (Note: Baturina herself is in trouble and has been rebuffed in her efforts to obtain government financial support -- septel.)

¶8. (SBU) Chigirinsky was poised to execute three Moscow landmark projects: Russia Tower, touted as Europe's tallest building and the world's tallest "green" building; Zaryadye, a luxury multi-purpose complex on the site of the former Rossiya Hotel adjacent to St. Basil's and the Kremlin; and, Crystal Island, a luxury city in what was to be the world's largest building, a pyramid intended to be four times the size of the Pentagon. All three have been quietly mothballed and Chigirinsky must now sell his real estate interests to pay back a USD 325 million "advance" that he took from Sibir.

¶9. (C) Kanukhin maintained that either the federal or Moscow government would find some way to complete at least Russia Tower, the centerpiece of Luzhkov's showcase Capital City office and apartment complex. The project was too far along to be abandoned. Moreover, it was a matter of Russian pride to complete it. President and CEO Michael Belton of the PIK Group's Storm Properties, however, disagreed, pointing out that only the foundation had been laid and that neither the financing, nor the demand for the completed space was there.

Mirax Owner Sells Yacht to Stay in Game

¶10. (C) The completion of Russia Tower has become a rallying point, however, for Mirax owner Sergei Polonsky, who recently refinanced a USD 200 million loan from Credit Suisse. After telling the media that businessmen had to be "responsible", he sold a number of luxury residential properties and his yacht and announced himself able and willing to finish Russia Tower. Gordeyeva was unsure how Polonsky would be able to

finance even a "shortened" Russia Tower, but speculated that the Moscow government would step in. David Simons, Director of Development for Giffels Russia, told us that Polonsky's chief goal was to ensure that he remained a player in Moscow's lucrative real estate sector once the crisis eased.

But Banks Will Be Left Holding the Bag

¶11. (C) According to Gordeyeva, beyond a few wily developers, the only other players left in the commercial real estate market would be the Russian banks (primarily Sberbank and VTB) who had refinanced the loans. She told us that many developers had been forced to use their hard assets (e.g., buildings) as collateral. Since it was likely that many developers would ultimately be unable to repay their loans, the banks would acquire the assets, which they intended to hold until the market turned around and they could sell them.

Comment

¶12. (C) Given the dropping demand for commercial property even prior to last September, it appears that commercial real estate may be slower to recover than other sectors once the downturn stabilizes. Banks that end up holding the assets of liquidated developers therefore will not be able to capitalize on an upturn in the market anytime soon.

BEYRLE